

Committee on Ways and Means

H.R. 4297, THE TAX RELIEF EXTENSION RECONCILIATION ACT OF 2005

One-Year Extension of Provisions Expiring in 2005

1. AMT Relief for Personal Tax Credits

The tax code includes many non-refundable personal tax credits, such as the dependent care credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, the Hope Lifetime credit, and the Lifetime Learning credit, among others. Claiming these credits may push an individual into the Alternative Minimum Tax (AMT). The provision allows non-refundable personal credits to be claimed against the AMT so that families continue to receive the full benefit of these tax credits.

2. State and Local Sales Tax Deduction

Individuals may claim a Federal income tax deduction for income taxes paid to State and local governments. Some States do not levy income taxes on their residents; instead, they finance their operations primarily through the collection of sales taxes. The provision creates parity among States by allowing all taxpayers the option to deduct their State and local sales taxes in lieu of their State and local income taxes.

3. Modified Research and Experimentation (R&E) Tax Credit

Businesses may claim a tax credit for qualified research expenditures. In general, the credit equals 20 percent of qualified research expenses in excess of a base amount in that year. The credit has regularly been extended since its creation in 1981 as an incentive to private enterprise to conduct additional research. In addition to the extension, the provision enhances the R&E credit by increasing the value of the alternative incremental credit and by adding a new alternative simplified credit.

4. Above-the-Line Deduction for Higher Education Expenses

Current law includes several tax incentives to enhance the affordability of higher education, such as tax-preferred Education Savings Accounts and tax credits for post-secondary education. The provision allows taxpayers to deduct up to \$4,000 (depending on income) of higher education expenses in lieu of claiming the Hope Scholarship or Lifetime Learning tax credits. The deduction is available "above-the-line." In other words, it may be claimed by all individual taxpayers whether or not they itemize their deductions.

5. Above-the-Line Deduction for Teacher Classroom Expenses

Business expenses incurred by employees may be deducted only if the employee itemizes deductions and only if the expenses exceed 2 percent of the employee's adjusted gross income (AGI). The provision allows teachers to deduct up to \$250 of out-of-pocket costs incurred to purchase books, supplies and other classroom equipment. The deduction is available to all individual taxpayers whether or not they itemize their deductions.

6. Authority to Issue Qualified Zone Academy Bonds (QZABs) for School Modernization

QZABs are tax-credit bonds which are issued by States and local governments to help repair schools, purchase school equipment and train teachers in economically distressed areas. Unlike typical "tax-exempt" bonds, QZAB holders may claim a Federal income tax credit in lieu of receiving tax-free interest payments. This allows States and local governments to finance their projects at a lower cost because the interest is paid by the Federal government. Projects financed with QZABs must meet certain requirements. For example, the bond issuer must secure private-sector contributions of cash, equipment, training or other property and services equal to 10 percent of the bond proceeds.

7. Enhanced Deduction for Donations of Computer Equipment

The tax deduction for corporate charitable donations is usually limited to the corporation's basis in the property. The provision allows corporations to claim an enhanced tax deduction equal to the lesser of basis plus half of the item's appreciation or twice basis for donations of certain computer equipment to schools or public libraries.

8. Work Opportunity Tax Credit (WOTC)

Employers may claim the WOTC if they hire individuals from groups that are considered to face barriers to employment, such as families receiving public assistance, high-risk youths, ex-felons, qualified veterans, and food stamp recipients under the age of 25. The maximum credit is \$2,400 and may be claimed during the individual's first year of employment. In addition to extending the WOTC, the provision also expands eligible hires by increasing the age limit for food stamp recipients from 25 to 35.

9. Welfare to Work (WTW) Tax Credit

Employers may claim the WTW tax credit if they hire individuals who have received public assistance for an extended period of time. The maximum credit is \$3,500 during the employee's first year of employment and \$5,000 during the second year. As with the WOTC, the credit is based on "qualified wages." However, qualified wages are defined more broadly for purposes of the WTW tax credit.

10. Tax Incentives for Business Activity on Indian Reservations

Indian reservations may face obstacles in attracting businesses and qualified workers. The tax code provides certain tax benefits to help spur economic activity on Indian reservations. Two of these benefits are extended on an annual basis.

- a. Wage tax credit – Employers receive a 20-percent tax credit on the first \$20,000 of wages and employee health insurance costs to the extent these costs exceed the amount paid by the employer in 1993.
- b. Accelerated depreciation – Businesses located on Indian reservations benefit from accelerated depreciation schedules for property that is primarily used to conduct business on the reservation. This allows the business to recover the cost of their investments more quickly.

11. Fifteen-Year Depreciation for Leasehold Improvements

The cost of leasehold improvements is generally depreciated over 39 years. The long recovery period does not recognize that structures frequently need to be modified to accommodate new tenants leasing the property. The provision reduces the depreciation period for leasehold improvements from 39 years to 15 years.

12. Fifteen-Year Depreciation for Restaurant Improvements

The cost of nonresidential real property is generally depreciated over 39 years. The provision reduces the depreciation period for restaurant improvements from 39 years to 15 years. The shorter cost recovery improves cash flow and recognizes facilities' wear.

13. Archer MSAs (Medical Savings Accounts)

Individuals may make tax-deductible contributions to an Archer MSA to pay for health care expenses. The distributions are tax-free if used to pay for eligible medical expenses.

14. Suspension of Limit on Percentage Depletion for Oil And Gas from Marginal Wells

Independent producers may use the "percentage depletion" method of accounting when filing their tax returns. This method of accounting allows the producer to deduct 15 percent of gross income each year, as long as the deduction does not exceed 100 percent of the property's net income in any year. The provision waives the 100 percent limitation so that independent producers may realize the full benefit of percentage depletion.

15. Tax Incentives to Revitalize the District of Columbia

Certain economically distressed areas in the District of Columbia are designated as the "D.C. Enterprise Zone." To help encourage development, certain tax benefits are available to eligible businesses in the Zone, such as zero capital gains rates. In addition, first-time

homebuyers in D.C. (not limited to the Zone) may claim a tax credit of up to \$5,000 of the purchase price of the home.

16. Possession Tax Credit for American Samoa

Under Section 936, a tax credit for investment and activities in certain U.S. territories has been available as an incentive to create jobs and investment in those areas. The provision extends the Section 936 credit for American Samoa to promote the retention of industry in that territory.

17. Excise Tax for Enforcing Mental Health Parity Rules

Under current law, group health plans that provide both medical benefits and mental health benefits are not allowed to impose dollar limits on the mental health benefits if the same limits are not also imposed on medical benefits. In general, employers who violate this rule are subject to a \$100 per day excise tax penalty (up to a cap) until the health plan is brought into compliance.

Two-Year Extension of Certain Expiring Provisions

1. Savers' Credit

Eligible individuals who make contributions to an IRA or qualified pension plan receive a Federal "match" in the form of an income tax credit for the first \$2,000 of annual contributions. The credit equals 50 percent of the contribution for individuals with AGI of \$15,000 or less (\$30,000 or less for married couples). The credit phases down to zero for individuals with AGI of \$25,000 or more (\$50,000 or more for married couples). Without action, the credit will expire after December 31, 2006.

2. Enhanced Section 179 Expensing for Small Business

Under current law, small businesses may expense (i.e., deduct in the first year) up to \$100,000 of investments in depreciable assets. The deduction phases out dollar-for-dollar to the extent the business's annual investments exceed \$400,000. Without action, the expensing limit will decline to \$25,000 and the phase-out threshold will decline to \$200,000 after 2007.

3. Brownfield Expensing

Under current law, taxpayers can expense (i.e., deduct in the first year) the costs incurred in cleaning up certain contaminated sites. The deduction may be claimed against regular tax and the AMT. The ability to expense remediation costs provides an incentive to clean up contaminated sites that are not included on the national priorities list. The proposal expands the definition of an eligible contaminated site to include sites contaminated by petroleum products. Without action, the benefit will expire after December 31, 2005.

4. Active Financing Exception

Subpart F of the tax code imposes immediate taxation on foreign subsidiaries of U.S. companies, even if their income has not been brought back to the United States. There is an exception from Subpart F for active financing income. The exception is necessary to keep the U.S.-based financial services industry on equal footing with its foreign-based competitors because no other country imposes current tax on financial services income earned abroad. The active financing exception also helps domestic manufacturers who finance sales of large equipment to foreign customers. In addition to extending the active financing exception, the provision also expands the exceptions from Subpart F to include cross-border payments of dividends, interest, rents, and royalties that are funded with active income that has not been repatriated.

5. Reduced Rates on Capital Gains and Dividends

Under current law, capital gains and dividend income are taxed at a 15-percent rate. The rate will be reduced to zero in 2008 for taxpayers in the 10- and 15-percent tax brackets. These rates will increase starting in 2009. The provision extends the reduced tax rates through 2010.

Miscellaneous Provisions

1. Simplification of Active Trade or Business Test

The provision simplifies the application of the active trade or business test to certain corporate distributions. By applying this test on an affiliated group basis, the provision applies the same standard regardless of whether a business is owned by a holding company or owned directly. As a result, the provision allows corporations to avoid costly and inefficient internal restructurings prior to engaging in certain corporate distributions to their shareholders.

2. Tax Treatment of Environmental Cleanup Funds

Under current law, income earned by certain environmental cleanup funds is taxable to the company that contributed to the fund. This is the case even though the taxpayer has permanently surrendered all control and dominion over the money in the fund. The provision treats environment cleanup settlement funds as governmentally owned (i.e., not subject to tax) if certain standards and requirements are met. Eliminating the tax surcharge will encourage more companies to establish settlement funds devoted to environmental cleanup.

3. Tax Treatment of Self-Created Musical Works

The provision provides capital gains treatment for self-created musical works when these works are sold by the artist. Under current law, such sales are taxed as regular income.

4. Tax Treatment of Permanent University Fund

The provision codifies and extends IRS rules that govern the tax treatment of tax-exempt bonds issued by the “Permanent University Fund.” This Fund is used to finance the activities of certain State universities.

5. Modification to the Tonnage Tax

The tonnage tax is an alternative tax regime for U.S.-flagged vessels that participate in commercial foreign trade. Vessels weighing more than 10,000 deadweight tons may elect into the tonnage tax. The provision reduces the weight threshold to 6,000 deadweight tons, thus allowing more vessels to be competitive by using the tonnage tax regime.

6. Enhancing Veterans’ Access to Affordable Mortgages

Certain States have a qualified veterans’ mortgage bond program that allows the State to finance affordable mortgage for veterans. Under current law, veterans are eligible for these mortgages only if they served prior to 1977. The provision expands eligibility for the program by repealing the requirement that veterans must have served before 1977.